TEESSIDE PENSION FUND

Administered by Middlesbrough Council

AGENDA ITEM 5

TEESSIDE PENSION FUND COMMITTEE REPORT

27 JUNE 2018

STRATEGIC DIRECTOR FINANCE, GOVERNANCE & SUPPORT – JAMES BROMILEY

INVESTMENT ADVISORS REPORT

1. PURPOSE OF THE REPORT

1.1 To update Members with the current capital market conditions, and set an appropriate short term asset allocation to best take advantage of these conditions.

2. RECOMMENDATIONS

2.1 That Members note the report and approve with the short term asset allocation.

3. FINANCIAL IMPLICATIONS

3.1 Decisions taken by Members in light of information contained within this report will have an impact on the performance of the Fund.

4. BACKGROUND

4.1 At each Investment Panel meeting, the Panel's Independent Investment Advisors (the Advisors) provide an update to Members on current global economic, political and market conditions, and recommend an appropriate short term asset allocation for the Fund given these conditions.

4.2 As Members are aware, a review of Advisors was carried out and as part of the tender exercise the previous Advisors' last Panel meeting was March 2017. Progress has not enabled new Advisors to be present for this meeting to provide advice to Members.

4.2 Attached as Appendix A is a report from the Head of Investments and Treasury Management. The report sets out the political, economic and market background since the previous meeting.

5. SHORT TERM ASSET ALLOCATION ADVICE

5.1 With the initial results from the Fund's Asset/Liability Study being presented at the last meeting, and in light of no Independent Investment Advisors to provide Members with investment advice and propose short term asset allocation, it is considered appropriate to look at protecting the valuation of the Fund given recent volatility in bond and equity markets, following recent geopolitical and economic news.

5.2 The Fund's now has a zero position in bonds, with cash as the only protection asset available. It is proposed that the Fund introduces a short term protection strategy, looking at protecting recent rises in the Fund's valuation through divestment from equities and protect equity values through use of derivatives.

5.3 Cash levels at the end of March 2018 was at 13% (£503 million). This level has risen recently to £677 million (as at 15 June 2018) through further divestment from equities. Cash balances have risen with divestment from Equities as part of the Fund's transformation plan ahead of pooling; some of this cash balance is to be redeployed at a future date. It is proposed that the controlled reduction of equities into cash continues over the next quarter with an upper target cash levels of £800 million (20% of the Fund).

5.4 In addition, investigations are already underway looking at an equity protection strategy. These are at a good stage with increasing clarity over an appropriate methodology. One issue to resolve is, when using derivatives as part of the strategy, collateral is required to provide security against the possibility of payment default by the opposing party. It is usual for collateral to be in the form of bonds, however, as stated earlier the Fund has divested from bonds. In order to correct this, the Fund will look at options for collateral, and may need to acquire bonds as collateral.

5.5 It is considered that in the long run, bond yields will rise to levels that do meet the actuarial requirements for the Fund and should continue to be avoided at these yield levels unless they are held as a short term alternative to cash or as part of an equity protection strategy in a collateral account.

5.6 Cash has built up as divestments from other asset classes have continued. Previously, this cash is primed to be invested when opportunities allow. It is always preferential for cash to be invested in higher returning assets, but at this time high cash levels is assisting with protecting the Fund, as a diversifier from Equity market downturns.

5.7 Cash levels should be allowed to rise in the short term towards the maximum level set at the customised benchmark for protection assets (20%). Should cash be required for bonds, as part of a collateral account for equity protection purposes, then cash can reduce to lower levels. It is accepted that if the value of other asset classes fall, particularly Equities, there is a possibility that the short term cash level can rise over the maximum set below.

5.8 Equity markets have risen strongly over the past few years, with additional volatility in currency markets, both of which have been beneficial to the Fund since the date of the last Actuarial Valuation with the Fund's high weighting in equities. The short term allocation strategy and range provides flexibility within this asset class, however, reducing equity levels is a big feature of the proposed new customised benchmark.

5.9 It is with both these factors in mind that the short term asset allocation range has been set to allow this flexibility until a strategy has been fully developed to implement the proposed new customised benchmark, should the Committee agree to it. The lower limit has also been lowered to provide an opportunity to divest after equity market levels have performed so strongly and as part of the Fund's transformation plan ahead of pooling.

5.10 Investment in direct property to continue on the same basis as previously presented to the Panel; make purchases on an opportunistic basis where the property has a good covenant, yield and lease terms. Further details on the property strategy will follow from the Fund's Property Advisors.

5.11 Investment in Alternatives, such as general and local infrastructure and private equity, offer the Fund diversification from equities and bonds. They come with additional risks of being illiquid, traditionally they have costly management fees and investment in the type of investment can be a slow process.

5.12 The Fund is considerably underweight its customised benchmark in this asset class and, providing suitable investment opportunities are available, the Fund should look to increase its allocation to this asset class up to the customised benchmark level. Activity has stepped up recently, with due diligence completed in a number of investment opportunities and due diligence in progress for others. In addition, this is a big feature in the proposed new customised benchmark, and an asset class where Border to Coast Pension Partnership can assist in the future.

5.13 The Fund's long and short term asset allocation strategies (based on the existing customised benchmark before implementation of the proposed benchmark following the Asset Liability Study) are summarised below, together with the short term asset allocation ranges for each asset class:

Asset Class	Current Customised Benchmark %	March Weighting %	LT Asset Allocation Strategy	ST Asset Allocation Strategy	ST Range %	Proposed New Benchmark %
EQUITIES:						
UK Equities	30	**30**	Reduce	Market Led	**25 – 32**	22
Overseas Equities	40	**47**	Reduce	Market Led	**42 – 50**	28
ILLIQUID ALTERNATIVES:						
Property & Property Debt	10	**8**	Increase	Opportunistic increase	**7 – 10**	15
Alternatives	5	**2**	Increase	Opportunistic increase	**1½ – 5**	15
PROTECTION:						
Bonds	12	**0**	Increase	Hold / Increase	**0 – 7½**	18
Cash	3	**13**	Reduce	Increase	**5 – 20**	2

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APPENDIX A

Investment Report June 2018

Geopolitical Background

The past quarter has been a busy one for geopolitical news, with major news stories from the US, Europe and here in Britain.

Brexit continues to dominate the UK political news. In May, the Prime Minister promised a robust response to a House of Lords proposed amendment to give Parliament a decisive say on Brexit. The amendment proposed would allow Parliament to determine the government's course of action if MPs rejected the deal or if the UK and EU were not able to reach an agreement of any kind. It would also give Parliament control of the process if the legislation enshrining the withdrawal treaty promised by ministers was not approved by 29 March 2019.

The House of Commons saw off this move to give MPs the decisive say on what happens over Brexit if they do not agree with the deal negotiated by the UK government. Following a meeting with the Prime Minister, Tory MPs were promised "input" into what the government would do if the UK faced a no-deal scenario. However, further details of amendments to the Brexit bill after talks with Tory "remainers" emerged showing that under the three scenarios set out in the bill (i.e. if MPs vote down the bill, if the Prime Minister announces no deal is reached by 29 January 2019 or if this date passes without a deal) a statement would be made to Parliament setting out next steps, but the vote would be a motion in neutral terms, merely stating the House has considered the statement.

The US looks intent on making enemies of its allies, while talks with North Korea look to have improved relations with its enemies. In May, the US pulled out of the landmark nuclear deal with Iran, vowing to re-impose sanctions on the country while also defying pleas from ally nations who had beseeched him to preserve the agreement. Two weeks later, US Secretary of State Pompeo upped the ante, demanding a more sweeping agreement as he insisted that Iran halt enrichment of uranium, allow nuclear inspectors "unqualified access" and end its involvement in Syria, Yemen and Lebanon, else face the strongest sanctions in its history. This move by the US was against the advice from their fellow NATO allies.

The Trump administration then announced that the US would impose tariffs on steel (25%) and aluminium (10%) imports from Canada, Mexico and the EU. Announcing the decision, Secretary of Commerce Wilbur Ross suggested that the decision reflected a lack of progress in talks to renegotiate NAFTA although the duties, which the US government claims are necessary on "national security" grounds, were first announced earlier this year as part of a crackdown by the US on China and its flooding of cheap industrial metals into global markets.

The EU said that it would retaliate against any US tariffs and the EC confirmed that the bloc would proceed with plans to impose its own duties on US product imports such as bourbon, motorcycles and peanut butter while Canada's Prime Minister said it would retaliate against its southern neighbour on a dollar-for-dollar basis by targeting US$12.8bn in US imports. Mexico said it would impose its own retaliatory tariffs on a wide range of products from US.

China promised a swift response to the tariffs, however the US announced further details of the tariffs worth $50 billion, including Chinese manufactured jet engines, water pumps and industrial dishwashers. Global equity markets reacted with the volatility expected whenever there are tariffs; markets almost always react negatively whenever uncertainty is introduced such as trade wars such as this.

Almost immediately after the fall out with G7 Members in Canada over the steel and aluminium tariffs saw the US President take the trip to Singapore to meet with the North Korean Leader. The outcome of the meeting looks favourable with denuclearisation by the North Koreans and the suspension of large scale military drills by the US and South Koreans.

In Europe, Italy's President Sergio Mattarella chose Giuseppe Conte prime minister designate and the original choice of Five Star and the League as Prime Minister. This proposal was agreeable to the populists as their leaders - Luigi Di Maoio and Matteo Salvini - dropped their insistence that Paolo Savona, an outspoken Eurosceptic be given the crucial post of finance minister. Indeed Mattarella had blocked that appointment in a move that populist leaders decried as "anti-democratic." Instead, Giovanni Tria, a little known economics professor, was named as finance minister while Savona was offered a less contentious portfolio.

Italy has been without a government for over two months since its general election and since the new government will be the first populist one in Western Europe, there are considerable worries that the region's third most significant economy's relationship with the EU could deteriorate and that Italy might instead, cosy up to Russia. However, the formation of the new government will at least temporarily allay those concerns, because it will remove for now the threat that snap elections will be called later this summer - a prospect which worried investors because it could have bolstered support for anti-EU parties. Furthermore, the alliance between the anti-establishment Five Star Movement and the League will have only a relatively narrow majority in the Italian Senate, easing concerns among investors and the EU over the new government's power.

Economic Background

Central Banks took centre stage with monetary policy updates dominating. In the UK, the Bank of England (BoE) reacted to news of lower quarter-on-quarter growth falling to 0.1% and inflations (CPI) falling 0.1% to 2.4%. Additional news of rising fuel prices and a slowdown in manufacturing led to the BoE Governor dampening down expectations of a rate rise ahead of the May meeting, and the BoE following that with the announcement of no move in rates, holding at 0.5%.

The Federal Reserve saw economic expansion and job gains as an opportunity to raise rates again to 1¾% - 2%, the seventh rise in rates since 2015 and a move towards monetary policy normality. The Fed's statement removed the call for "gradual" adjustments to monetary policy, indicating that the pace of rate rises could accelerate, US commentators are expecting two more rate rises in 2018, making four in total, the first time since 2006.

The European Central Bank (ECB) has confirmed it will end a huge programme to stimulate the Eurozone economy in December. The ECB will stop its bond-buying scheme, worth €30bn a month, despite a recent slowdown in the bloc's recovery. The move is a major step towards dismantling the policies brought in to stabilise the Eurozone in the wake of the financial crisis. However, the ECB kept interest rates on hold at 0% at its June meeting.

Market Background

Equity market, have performed positively since the start of this quarter (to 15 June 2018) with very strong positive returns from the Fund's last Actuarial Valuation:

	From 31/03/2016	YTD	QTD
	%	%	%
FTSE All-Share (UK)	33.7	1.7	9.2
S & P 500 (US)	52.0	6.8	11.5
Euro Stoxx 600 Ex UK (Europe)	39.2	0.4	5.3
Topix 500 (Japan)	50.5	2.9	5.8
MSCI Asia Pacific Ex Japan	58.8	2.0	5.2

The above returns are all rebased back to GB Pounds, and take into effect both the currency and index moves.

In the past it has been reported to the Panel that Bond yields are not sufficient to meet the actuarial rate of return, as calculated by the Fund's Actuary. The table below sets out the yields of the major market's 10 year bond yields as at 31 March 2016, 31 December 2017 and 15 June 2018:

10 Year Bond Yields	31/03/2016	31/12/2017	23/03/2018
UK	1.414	1.188	1.325
US	1.770	2.406	2.921

10 Year Bond Yields	**31/03/2016**	**31/12/2017**	**23/03/2018**
Germany	0.152	0.423	0.401
France	0.485	0.780	0.730
Switzerland	-0.359	-0.178	-0.059
Japan	-0.035	0.043	0.030
Australia	2.489	2.630	2.693

With the exception of the US, all yields tightened this quarter to 15 June 2018. The US widened more or less in line the rate rise. Whilst bonds are normally at the heart of pension fund investment assets, at these yields they are still well short of the required rate of return of 4.7% they should only be considered as a proxy for cash (short-dated bonds) or as collateral as part of an equity protection strategy.

Paul Campbell – Head of Investments & Treasury Management

18 June 2018